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THE INTERIM

JULY 1997

HELENA, MONTANA

VOL. XI NO. 2

COMMITTEE ON INDIAN AFFAIRS

Committee to Hold First Meeting...The Committee on Indian Affairs will hold its first meeting on Thursday, July 24 in Room 108 of the Capitol. The meeting will begin at 10 a.m with the election of officers.

Committee to Adopt Work Plan...This interim, the Committee will coordinate efforts to develop recommendations that will increase employment, income, and economic development on Indian reservations. The recommendations must include methods to reduce the expenditures of the Department of Public Health and Human Services (DPHHS) and the Department of Corrections on reservations as a result of the increased employment and income. The Committee will work with the governor's office, the Coordinator of Indian Affairs, tribal governments, and DPHHS in this effort to find solutions to the economic problems that have traditionally plagued Indian reservations.

In addition to the work outlined above, the Committee plans to continue its visits to Indian reservations over the next 18 months. The Committee is tentatively planning to make two such visits.

Committee to Hear From State Agencies...The Committee will also hear reports from state agencies involved in negotiations with tribal governments in Montana. Tentatively scheduled to report are the Department of Transportation, the Gambling Control Division, the Reserved Water Rights Compact Commission, and the Indian Child Welfare specialist from DPHHS. The Committee will also hear a report from Wyman McDonald, the state Coordinator of Indian Affairs.

For further information about the meeting or to be placed on the interested persons' mailing list, please contact Connie Erickson, Legislative Services Division, (406)444-3064 or by e-mail at <cerickson@mt.gov>

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INTERIM PROPERTY TAX COMMITTEE

Interim Property Tax Committee to Meet...The Interim Property Tax Committee, created by the adoption of SB 195 (1997), will hold its organizational meeting on July 25 in Helena. The meeting is scheduled to begin at 9 a.m. in Room 104 of the Capitol. Items anticipated to be part of the agenda include election of officers, an overview of the legal underpinnings of property taxation in Montana, an historical perspective of "market value" as the cornerstone of property taxation, and, potentially, a brief look at the disposition of property taxes in Montana.

The Committee is anticipated to devote the afternoon to reviewing a proposed plan for conducting the study of Montana's property tax system required in SB 195. Members of the Committee are Senators Del Gage, Gerry Devlin, Mike Sprague, Steve Doherty, Linda Nelson, and Barry "Spook" Stang and Representatives Bill Carey, Dan Harrington, Emily Swanson, Alvin Ellis, Jr., Robert Story, Jr., and Lila Taylor.

Questions or comments about the study may be directed to Dave Bohyer, Legislative Services Division, (406)444-3064 or by e-mail at <dbohyer@mt.gov> . The public is invited and encouraged to attend.

LEGISLATIVE FINANCE COMMITTEE

LFC Elects New Officers....At its organizational meeting on June 19, the Legislative Finance Committee elected Senator Chuck Swysgood as presiding officer for a two year term. The Committee also elected Representative Matt McCann as vice presiding officer and Senator Eve Franklin as secretary.

Highlights of selected reports heard by the Committee are presented below.

Legislative Fiscal Report...The Committee met jointly with the Revenue Oversight Committee to hear the Legislative Fiscal Analyst present the Legislative Fiscal Report for the 1999 biennium. The report consists of three volumes: an overview volume and two volumes that detail revenue projection assumptions and individual agency/program budgets. The ending general fund balance for the 1999 biennium is projected to be \$24.5 million. Significant actions by the 55th Legislature include:

- * an increase in general fund and total expenditures over the 1997 biennium of 5 percent and 6 percent, respectively. The total general fund budget is \$2.1 billion and total funds are \$4.9 billion;

- * general fund increases in corrections, \$48.5 million (over 52 percent of the total general fund increase), and public school support, nearly \$25 million. The largest increase in total funds was for human services, which at \$96 million was one-third of the total increase;
- * mitigation of the impacts of cyclical property tax reappraisal, which reduced general fund projected revenues by \$75 million for the 1999 biennium;
- * a reduction of present law funding below the executive recommendation of \$47 million, primarily due to revised Medicaid/human services and K-12 enrollment projections;
- * approval of \$115 million in new initiatives, primarily to meet prison population expansion, increased BASE support for public schools, and the state employee pay plan; and
- * approval of \$121.6 million for 65 projects in the Long Range Building Program, including \$43.3 million from general obligation bonds. The Legislature also appropriated funding to purchase Virginia City/Nevada City historical properties;

The report also forecasted potential funding issues for the 2001 biennium with an estimate of present law general fund revenues and expenditures. Based on conservative estimates of the growth of present law costs, including a 24 percent growth in corrections costs and a 2.6 percent growth in revenues, the report concludes that the 1999 Legislature will have sufficient funds for a balanced present law budget in the 2001 biennium, but no excess to cover contingencies such as supplemental requests and new initiatives. The highways special revenue account, however, is projected, based on present law revenues and expenditures, to have a balance of less than \$2 million at the end of the 1999 biennium and a deficit at the end of the 2001 biennium of over \$22 million.

The overview volume will be mailed to all legislators. Volumes 1 and 2 (revenue projections and agency budgets) are available to all legislators on request, and legislators are encouraged to pick up the volumes in the Legislative Fiscal Division (Room 105) during their next visit to the Capitol. All three volumes are being distributed to agencies, and interested members of the public may purchase any or all three volumes through the Legislative Services Division, (406)444-3064. Volumes 1 and 2 cost \$25 for the set; the overview volume is \$5.25.

Virginia City/Nevada City Historical Properties Purchase...Brian Cockhill of the Montana Historical Society reported to the Committee on the completion of purchase

of the "Twin Cities" Bovey properties and the contract negotiated with a Virginia City business to open and operate all properties this summer. The commission to develop a business plan and operate the properties has been named.

The members are Representative Karl Ohs, Senator Dale Mahlum, David Mihalic, John Lawton, Jeanette McKee, Maureen Averill, Jeffrey Safford, Mike Gustafson, Rosana Skelton, Patrick Graham, Brian Cockhill, and Linda Reed.

Beer Tax...The Committee heard a report on an unintended shift in allocation of beer tax funds from the general fund to cities and towns as a result of the enactment of HB 166, the dedicated revenues bill. The difference results from conflicting interpretation of existing statutes. As a result, the 1999 biennium general fund is projected to be about \$2.0 million less than anticipated.

LFD Interim Workplan...The Committee approved an aggressive work plan for the Legislative Fiscal Division for the coming biennium. The plan reflects a significant increase in statutory and other duties for both the Committee and staff as a result of legislation passed by the 1997 Legislature, including a highways fund study, property tax reform study, corrections oversight study, and replacement of statewide management/budget systems. The plan also includes a review of revenue estimation procedures, staffing for the Committee on Postsecondary Education Policy and Budget, and support to the Revenue Oversight Committee in addition to fiscal projects for the Finance Committee.

Subcommittee on Revenue Dedications/Statutory Appropriations...Chairman Swysgood appointed four members to a subcommittee for the statutorily required biennial review of revenue dedications and statutory appropriations. Subcommittee members are Senator Jenkins, Senator Jergeson, Representative McCann, and Representative Vick.

GAMING ADVISORY COUNCIL

Gaming Council to Meet...The Gaming Advisory Council will meet on Wednesday, July 9 in the old Supreme Court Chambers, Room 325, in the Capitol, beginning at 9 a.m. The agenda includes remarks from Attorney General Joe Mazurek, a review of legislation from the 55th legislative session, and a division report from newly-appointed Gambling Control Division administrator Jim Oppedahl.

For further information about the meeting or about the Gaming Advisory Council itself, please contact Wilbur Rehmann, Gambling Control Division, 444-1971.

ENVIRONMENTAL QUALITY COUNCIL

EQC Meets in June... The Environmental Quality Council (EQC) met on June 3 and adopted an interim work plan. A bipartisan and collaborative tone for the interim was set early in the meeting when the 17-member Council unanimously elected for the first time in its history bipartisan co-presiding officers. The co-presiding officers are Senator Ken Mesaros and Representative Vicki Cocchiarella.

The Council also paid tribute to Representative Dick Knox who passed away shortly after the 1997 Legislature ended. The Council dedicated a plaque in Rep. Knox's honor and will plant a tree in his memory at the State Capitol in September. More details will follow on the tree planting ceremony.

Set out below is a summary of the Council's 1997-98 interim activities.

Montana Growth Issues...Based on the information generated in the Council publication Our Montana Environment...Where Do We Stand? and requests from Senators Don Hargrove and Greg Jergeson and Representative Emily Swanson, among others, the Council made growth management in Montana its top priority. The Council directed its staff to generate an issues paper with possible study options for the interim. The Council will solicit public comment and finalize its interim work plan on this issue in September. Possible study issues may include generation of growth data across the state, review of Montana's subdivision laws, maintaining Montana's family farms and ranches, and open space incentives, among others.

Waste Tire Study...In Montana, the vast majority of waste tires destined for disposal are landfilled with household wastes in municipal landfills, separated from the waste stream and landfilled in dedicated tire only disposal sites (monofills), or simply separated and surface stored for "future recycling" or "resource recovery" opportunities. Senate Bill 332 requested that the Council examine this current waste tire management situation and determine if there are "better" ways to address this component of the waste stream. The Council decided to establish a working group to review waste tire issues and come up with viable solutions. The Council is required to report its findings to the 1999 Legislature.

Montana Environmental Policy Act (MEPA) Implementation and Oversight...In response to heightened public awareness and involvement in the MEPA process, state agencies requested the Council during the 1991-92 and 1993-94 interims to take a proactive role in assisting agency personnel in on-the-ground implementation of MEPA. The Council initiated a MEPA implementation project to familiarize state agency personnel with the benefits of effective and efficient MEPA implementation. The project included a MEPA process handbook, training seminars (over 600 state agency people trained), a document review system, a MEPA liaison position, and the George Darrow MEPA award.

The 1995 Legislature amended MEPA to clarify that state agencies shall evaluate regulatory impacts on private property, to exempt the legislature from MEPA review, and to elevate the burden of proof for a party challenging an agency's decision

not to conduct an EIS. During the 1995-96 interim, the Council created a MEPA subcommittee that developed guidelines for agencies to implement the regulatory impact analysis.

This interim the Council has decided to update the MEPA process handbook and to provide general MEPA implementation training seminars for state agencies, the regulated community, and the general public. The Council will also be requesting updates on all of the major environmental impact statements being conducted by state agencies this interim.

Montana Indicators Project...The 1995-96 Council directed the production and distribution of Our Montana Environment...Where Do We Stand as a way to fulfill the Council's statutory directives to continually and systematically analyze conditions and trends in Montana's human environment. The effort was an attempt to reproduce statewide environmental condition data published in a 1975 Council report and to use the data as indicators of environmental trends and conditions. The report has been well received with the Council distributing 2,272 copies across the state so far.

The Council decided at its June meeting to utilize the report as the basis for Council recommendations to the Legislature and to evaluate and prioritize environmental issues of concern. The report will be disseminated upon request.

Water Policy... The Council has extensive water policy duties. Before 1995, these duties were assigned to a separate entity, the Water Policy Committee. The 1995 Legislature eliminated the Water Policy Committee and transferred those duties to the Environmental Quality Council.

This interim, the Council will proactively focus its efforts on overseeing the implementation of House Bill 546, a bill clarifying the Department of Environmental Quality's (DEQ) role in monitoring and assessing the quality of Montana's waters and further directing the development of TMDLs (Total Maximum Daily Loads) for those waters determined to be threatened or impaired. Other issues that the Council may address include dam-related issues, stream access, water rights adjudication and permitting, 310 permit issues/river corridor protection, flood planning and control, wetland regulation/conservation, federal Clean Water Act reauthorization, ground water assessment and monitoring, and watershed planning and management.

Compliance and Enforcement Agency Reporting...The 1997 Legislature passed (and the governor signed) House Bill 132, requiring state environmental programs to biennially report to the EQC on compliance and enforcement activities and results. The Council will be working with these programs to generate reporting methods and content that will provide a sound basis for continued evaluation and comparison of Montana's implementation of its natural resource and environmental laws.

Primacy... In response to a recommendation from the 1995-96 HJR 10 enforcement and compliance study, the Council will provide legislative oversight of DEQ and EPA discussions on primacy in Montana. This oversight will include updates on how the DEQ/EPA relationship evolves. In addition, the Council agreed to continue

its evaluation of primacy issues on Indian reservations.

Voluntary Best Management Practices (BMPs)...The Council has been intrigued with the use of voluntary BMPs as one of the possible tools to promote compliance with environmental and natural resource laws. The Council decided to further evaluate the use of BMPs across a variety of programs, especially as they relate to water quality protection.

General Legislative Oversight...The Council has general legislative oversight for a number of environmental and natural resource programs and issues. This interim the Council will receive updates on the Kendall mine closure, voluntary contaminated site clean-up progress, forest management programs, hazardous and solid waste management, tribal/state primacy issues, environmental self audit legislation implementation, DEQ restructuring, utility restructuring, energy development and conservation, and new federal air quality regulations.

New EQC Publication...The Council, in conjunction with the Montana University System Water Resources Center, has published "A Guide to Montana Water Quality Regulation". The Guide summarizes the morass of water quality laws and regulations in easy-to-understand language. If you would like a copy, contact EQC staff at (406)444-3742.

EQC Adopts Interim Calendar...The Council adopted the following interim meeting calendar:

Tuesday, June 3, 1997
Thursday and Friday, September 18 and 19, 1997
Friday, November 14, 1997
Thursday and Friday, January 8 and 9, 1998
Friday, March 13, 1998
Friday, May 8, 1998
Friday, June 26, 1998
Thursday and Friday, September 10 and 11, 1998
Friday, October 30, 1998
Friday, December 4, 1998

These meeting dates are subject to change and do not reflect meetings of any subcommittee that the Council may create.

Next Meeting in September...The Council will hold its next meeting on September 18 and 19 at the Capitol in Helena.

For more information about the Council, please contact the EQC staff at (406)444-3742.

REVENUE OVERSIGHT COMMITTEE

Committee Meets June 19...The Revenue Oversight Committee held its first meeting of the interim on Thursday, June 19 in Helena. The Committee elected Senator Mike Halligan as presiding officer and Representative Chase Hibbard as vice presiding officer. The last issue of **THE INTERIM** listed the members of the Committee. However, Senator Bill Wilson has replaced Senator Fred Van Valkenburg.

The Committee met jointly with the Legislative Finance Committee to review the expenditure and revenue report prepared by the Legislative Fiscal Analyst. For coverage of the joint meeting please see the Legislative Finance Committee article in this issue.

Revenue Estimating Improvements a Priority...One of the most important duties of the Revenue Oversight Committee is the development of revenue estimates for the Legislature. The Committee is required under 5-18-107, MCA, to prepare an estimate of the amount of revenue projected to be available for legislative appropriation during the upcoming biennium. The Committee's estimate is the Legislature's current revenue estimate until amended or finally adopted by both houses. The statute goes on to say that it is intended that the Legislature's estimates and underlying assumptions be used by all agencies in estimating revenues and costs, including the preparation of fiscal notes. In the past, the revenue estimating process has worked reasonably well. The practice of the Committee has been to consider recommendations from both the Legislative Fiscal Division (LFD) and the Governor's Budget Office. Often times, outside experts provided insights for the Committee's consideration. The process, however, broke down during the last legislative session. In December 1996, the Committee met to adopt the economic assumptions used in the formulation of the revenue estimates for the 55th Legislature. The LFD and the Governor's Budget Office each presented their recommendations regarding economic assumptions and the associated revenue estimates. Their respective estimates differed by about \$64.7 million. Unfortunately, the LFD and the Budget Office could not readily explain to the Committee's satisfaction the reasons for the differences in the estimates. The Committee ultimately adopted most of the LFD's recommendations, but with a certain amount of misgivings. The confusion and frustration experienced by the Committee carried over into the legislative session. Although the differences were finally resolved, the sense of frustration and confusion lingered. In a letter written after the end of the session, Senate President Gary Aklestad and Speaker of the House John Mercer requested that the Committee look at ways to improve the revenue estimating process. Governor Marc Racicot made a similar request of the Committee.

In response to the legislative and executive branch requests and to meet the needs of the Committee, the LFD and the Budget Office presented proposals to improve the revenue estimating process to the Committee at the June 19 meeting. The purposes of the proposals are to improve working relationships between the legislative and executive branches, facilitate the exchange of information, and establish time lines for the development of revenue estimates. The Committee agreed that the

best way to achieve the objectives of the proposals was to create a subcommittee to work with the LFD and the Budget Office. Senator Halligan appointed Senators Bob Depratu and Bill Wilson and Representatives Joe Tropila and Bob Story. The subcommittee will hold its first meeting on Thursday, July 24 in Room 437 of the State Capitol. The ultimate goal of this exercise is to ensure that the Legislature can make informed decisions based on a clear understanding of how revenue estimates are derived.

Crow Tribe Coal Severance Tax Lawsuit--Day of Reckoning?...Jeff Martin, Committee staff, informed the Committee that the seemingly endless and tortuous litigation related to the Crow Indian Tribe lawsuit for refund of coal severance taxes and coal gross proceeds taxes may soon come to an end. The lawsuit has a long and complicated history dating back to 1978 when the Crow Tribe filed in federal district court for a declaration that Montana's coal severance tax and coal gross proceeds taxes were preempted by federal law for coal produced on the Crow Indian Reservation as well as the so-called Ceded Strip on which the Tribe still held the mineral rights. Westmoreland, Inc., operating under a lease agreement with the Crow Tribe, paid coal severance taxes to the state and coal gross proceeds taxes to Big Horn County. In 1987, the Ninth Circuit Court of Appeals held that Montana's coal taxes imposed against coal production on tribal lands were invalid. As a result, severance taxes of about \$23.4 million and coal gross proceeds taxes of a little over half a million dollars, plus accumulated interest, were turned over to the Crow Tribe. The refunds were contained in escrow accounts established in 1983 for coal severance taxes and in 1987 for gross proceeds taxes.

Still to be settled is whether restitution for severance taxes illegally collected by the state between 1975 and 1982 (\$46.8 million, plus interest) and for coal gross proceeds illegally collected by Big Horn County between 1975 and 1987 (\$11.4 million, plus interest) is owed to the Crow Tribe. The tribe had also sought damages for economic loss associated with the cancellation of a lease agreement with Shell Oil Company that the tribe claimed was caused by the imposition of coal production taxes. Last summer the Ninth Circuit Court of Appeals overturned U.S. District Court Judge Shanstrom's decision to dismiss the tribe's claim for retroactive relief for the disputed coal taxes but upheld the decision to dismiss the claim for damages associated with cancellation of the lease with Shell Oil. The appeals court directed the state and Big Horn County "to disgorge the improperly collected taxes" and to resolve the plaintiffs' request for prejudgment interest.

The state has appealed that decision to the U.S. Supreme Court. If the high court declines to review the case, Montana and Big Horn County will be required to refund the taxes plus postjudgment interest to the Crow Tribe. The principal and postjudgment interest would amount to over \$60 million. A complicating factor is that Big Horn County claims that the state should be responsible for the county's share of the gross proceeds taxes for schools that was allocated under the state school foundation program. The final amount due the tribe would depend on the determination of prejudgment interest, and that could take the federal courts several years to resolve.

The Crow Tribe told the Committee that the tribe has appealed the dismissal

of the claim for economic damages. If the Supreme Court decides to review the case, a decision would likely occur early next year. The Tribe also told the Committee that it would be willing to negotiate the issue of prejudgment interest if the Supreme Court decides in favor of the tribe. But the fiscal catastrophe looming on the horizon for these many years may soon unleash its full fury upon the state. It will be the Legislature's difficult task to confront the aftermath.

Review of Interim Activities--Tax Analysis of Utilities and Other Duties...The Committee has been assigned the task this interim of conducting a tax analysis of the electric and natural gas utilities. During the last session, the Legislature enacted Senate Bill No. 390 to restructure the electric utility industry and Senate Bill No. 396 to restructure the natural gas utility industry. Both bills directed the Committee to analyze the amount of state and local taxes derived from the previously regulated utilities and to recommend legislative changes, if any, establishing comparable tax burdens on participants in the respective markets. At the Committee's next meeting, staff will present background reports describing the major implications of restructuring as well as a study plan for the Committee's consideration. The formulation of the study plan will involve the active participation of electric and natural gas utility "stakeholders" in the state. Because restructuring is such an important national issue, a high level of expertise in all aspects of restructuring exists around the country. The elements contained in the study plan would utilize that expertise. In addition, Rep. Hibbard is a member of a electric utility taxation working group sponsored by the National Conference of State Legislatures. The group consists of legislators, legislative staff, and industry experts. The Committee anticipates that the working group's efforts will be an important part of its analysis.

The Committee deferred until the next meeting whether to undertake a study of the new restaurant beer and wine license system enacted by Senate Bill No. 354 as well as the liquor quota system in general. The idea for the study came from Senate Joint Resolution No. 20 introduced in the wake of Senate Bill No. 354. The resolution passed the Senate but died in the House. Mark Staples, Montana Tavern Association, contended that a study will occur as a matter of course as the new law is implemented and the effects on beer and wine licenses held by other establishments are reviewed.

Staff also highlighted the Committee's statutory responsibilities. These include, among others, oversight of the Department of Revenue, the preparation of revenue estimates for the ensuing biennium, coal tax oversight, review of negotiated tax settlements between the state and Indian tribes, and the investigation and issuance of reports on any matter concerning taxation.

Department of Revenue Reports...Mary Bryson, Director, Department of Revenue, summarized legislation enacted last session affecting the Department. The passage of Senate Bill No. 195 has broad implications for the Department as well as for taxpayers in the state. The bill delays the reappraisal process for 10 years and phases in new appraised values for class four residential and commercial property and for agricultural and forest lands. It also requires the Department to value new construction and reclassified property in a manner consistent with the way similar

property was valued in 1996. The bill also revises the property tax limitation laws under I-105. The Department has promulgated temporary rules (effective August 7, 1997) to implement the provisions of the new law. These rules must be in place before assessment notices may be sent to taxpayers and before budgets are adopted by local governments. Permanent rules will go through the normal review and comment process and will be effective October 1. Because the next reappraisal cycle was delayed for 10 years, the Legislature reduced the number of property appraisal employees. According to Bryson, the Department will reduce its staff by 33 people. Most of the reduction will occur through early retirement.

Bryson also responded to a legislative audit report that found that the Department has not updated the productive capacity of agricultural land since the 1970s. According to the audit report, this situation could result in inconsistent and inequitable taxation of agricultural land. Bryson said that report does not indicate that the values of agricultural land are incorrect. She also said that an update would be extremely expensive and time consuming. The audit report also criticized the Department for not including all intangible property in the property tax base. Bryson said the Department would move cautiously in the valuation of intangibles for property tax purposes in consultation with the Revenue Oversight Committee. Both these issues will be reviewed by the Committee during the interim.

Next Meeting Scheduled...The Revenue Oversight Committee will next meet October 10. Questions about the Committee and its activities may be directed to Jeff Martin, Legislative Services Division, by calling (406) 444-3064.

HOUSE BILL NO. 615

Gambling Commission Created...House Bill No. 615 establishes an interim commission to oversee, publicize, and report on an objective study of the socioeconomic impacts of gambling in Montana. The commission consists of 5 members appointed by the governor, including one each from the University of Montana and Montana State University, a mental health professional, a business owner (with no financial interest in a gambling enterprise), and a person with a doctorate in a social science that is pertinent to socioeconomic analysis. The commission will receive staff support from the Legislative Services Division (LSD).

The main tasks of the commission and staff are to issue a request for proposals, select a qualified contractor to conduct the study, receive and evaluate progress reports from the contractor during several meetings over a 12-month period, and publish a final report.

While no legislator will serve on the commission, the bill requires that a report documenting the study results be submitted to the Legislature on or before September 1, 1998. The report may include draft legislation. The commission is also required to present its findings to the public before October 1, 1998.

HB 615 provides a \$100,000 appropriation from state lottery funds to support the work of the commission and the LSD staff and to pay for the study.

For further information, contact Stephen Maly, Legislative Services Division, at (406) 444-3064 or Susan Ames, Governor's Office, at (406)444-3111.

THE BACK PAGE

Retail competition is becoming a reality for one of the last remaining government regulated monopolies: the electric power industry. Almost every state is reviewing the electrical business with the idea in mind to use competition to lower costs. Several states, including Montana, have already enacted legislation or adopted policies to implement customer choice or have supported retail competition and restructuring. California, New Hampshire, Montana, New York, and Pennsylvania are the first states to enact legislation to provide for the orderly transition from regulated monopoly to a competitive environment, while Arizona, Maine, Massachusetts, New Jersey, Oklahoma, Rhode Island, Vermont, and Wisconsin have endorsed the concept. Unlike Montana, many of these states promoting competition have electricity prices that are higher than the national average. A few other states are running pilot programs to see if competition will work.

The trend toward competition, or "retail wheeling", will have profound effects on electric energy producers, suppliers, consumers, state and local governments, and even on our vocabulary. Proponents of competition argue that competition will lower prices, while critics fear that the only beneficiaries will be large industrial customers. There are many complex issues that must be resolved by the states as competition moves forward. Some of these issues include:

- maintaining reliability, safety, and universal service for all customers;
- providing consumer protection by preventing cost-shifting among customers;
- ensuring that all consumers continue to fund environmental and social programs;
- ensuring that legitimate stranded costs of the electric industry are recovered and developing appropriate credit mechanisms for the recovery; and
- determining the revenue impact on state and local governments.

To help states better understand the issues and implications of competition in the electric utility industry, the New York State Assembly and the National Conference of State Legislatures (NCSL) with the National Council on Competition and the Electric Industry (NCCEI) hosted a conference on "The Electric Industry in the Balance: The Legislative Role for Reform" in New York City, May 29 and 30. Participants at the conference included legislators, legislative staff, and representatives from private and public utility interests from across the nation. This month's "The Back Page" article provides a summary of some of the trends and issues associated with electric utility restructuring.

"FREIGHT TRAIN, FREIGHT TRAIN GOING SO FAST"

By Jeff Martin, Research Analyst
Legislative Services Division

INTRODUCTION

The conference on electric utility restructuring provided a comprehensive summary of the major issues related to the debate about reforming the electric utility industry. Plenary sessions included an update on changes in the electric industry, stranded costs, and "credit enhancement" mechanisms (paying for stranded costs). Concurrent sessions included taxation of the competitive electric industry, environmental issues, market power in the new markets, universal service and consumer protection, safety and reliability, and public programs in renewable energy and conservation.

Matthew Brown, Director, NCSL, Energy Project, presented a general overview of the issues raised during the course of the conference. His synopsis provides the framework for the balance of this article. The themes developed by other presenters are woven into that framework and the discussion that follows.

The goal of restructuring is to provide a secure and affordable supply of energy under a competitive environment. Brown pointed out that the debate about restructuring is complex, with great implications for the economic and environmental vitality of the states. The initial lure of restructuring is the potential savings that may result from a competitive market in utility services. While cost savings may be realized in states with high energy rates, they may be more difficult to achieve in other states. He suggested that states considering reforming the electric utility industry develop a legislative checklist to lay out the issues for a comprehensive legislative reform package. The checklist would include:

- (1) maintaining a reliable and affordable electric system;
- (2) paying for the transition from monopoly to competition; and
- (3) implications for state and local revenue.

MAINTAINING A RELIABLE AND AFFORDABLE ELECTRIC SYSTEM

An important theme in Brown's discussion was the risk in a competitive market of over reliance on short-term price signals for planning purposes. The cooperation of utilities in regulated markets, a reasonable return on investment for reliability, and a significant amount of excess capacity ensured a reliable supply of electricity. Under competitive markets the likelihood of brownouts or blackouts increases unless new institutions are

created that ensure a reliable supply. Short-term prices could encourage the operators of electric generators to use only the cheapest fuels at the expense of developing a diversified fuel system to guard against interruptions in the supply of electricity. A competitive system must be as reliable as the current system. According to the NCCEL, system reliability has two components--adequacy and security of supply. Adequacy is the ability of the electric system to supply the aggregate electrical demand of customers at all times, taking into account scheduled and unscheduled outages of system facilities. Security is the ability of the electric system to withstand unanticipated loss of system facilities.

Large industrial and commercial customers may have the greatest opportunity to benefit in a competitive market. Without legislative safeguards two classes of customers could be adversely affected by restructuring. Lower income customers may face a greater risk of power shut-offs or burdensome conditions for continuation of electric services. Another group is rural electric cooperative customers. Under the regulated structure, these customers are protected by universal service and affordable rates. In many instances these customers who are generally more expensive to serve may be aggregated in a customer base of "economically desirable" customers. If the current system of aggregation breaks down, then mechanisms for creating a new aggregation of customers that include rural customers should be included in restructuring legislation.

One of the more difficult tasks may be the education of customers regarding the service choices that are available. Brown advocated that legislation include ways to educate customers about how to evaluate choices offered them.

PAYING FOR THE TRANSITION FROM MONOPOLY TO COMPETITION

Perhaps one of the most controversial aspects of the trend to competition is whether shareholders of a previously regulated utility should be allowed to recover stranded costs related to the utility's investments. Stranded costs represent the book value of an asset in excess of its (deregulated) market value. Stranded costs (as defined by NCCEL) include costs incurred pursuant to a regulatory or contractual obligation, costs that are reflected in cost-based rates, and cost-based rates that exceed the price of alternatives in the market place.

Stranded costs arise as the result of competition, they do not exist in a regulated environment. Professor Bernard Black, Columbia Law School, said that utility assets that remain subject to rate-of-return regulation should not be included in the calculation of stranded costs. Generally, power production assets would be included in the calculation but assets associated with the transmission and distribution of electric power would not. He also said that it is difficult to determine whether certain assets, particularly regulatory assets, are power production assets or

transmission or distribution assets. He emphasized that deregulation must occur before stranded costs or investments can be determined. Quoting Professor Black at length:

An effort to estimate stranded investment before deregulation actually occurs and before generation assets are actually sold, will be only an estimate. Such an *ex ante* estimate should not be used for several reasons. First, even if there is an actual sale of generation assets prior to deregulation, the market values of the assets won't reflect the true value of the assets, because investors will insist on a discount to allow for regulatory uncertainty. Second, it will be hard to sell generating assets prior to deregulation. If there is no actual sale, and utility commissions rely on estimates offered by utilities, the utilities will have an incentive to exaggerate their stranded investment. The investment will depend on a battle of competing experts, instead of on true market prices. The utility's experts will place a low (market) value on the assets, experts hired by utility customers will place a high value on the assets, and the utility commission will have to decide whose experts to believe. That's great business for experts, but a lousy way to measure stranded investment.

Thus, the best way of obtaining the market value of generating assets is to require the utilities to sell their power generating assets. Professor Black went on to say that real competition in power generation requires the break-up of vertically integrated electric utilities in order to prevent power plants owned by utilities from receiving favored treatment when selling power to transmission or distribution networks owned by the utility.

Proponents for the recovery of stranded costs argue that utilities should be compensated for these costs because the costs were approved by the state regulatory agency, while opponents maintain that stranded costs are the result of poor business decisions. They also claim that stranded costs may be allocated unfairly.

The states that have enacted restructuring legislation, including Montana, all provide for the recovery of "reasonable" stranded costs through the issuance of bonds. The principal and interest of the bonds is paid by a fee on all electric customers in the state. The amount of the principal is equal to the book value of a utility's net assets, minus the sales price that the utility could obtain in a competitive market. Because the debt of the utility is restructured on more favorable terms (i.e., lower interest rates), customers would pay lower rates than otherwise would be available. There is a risk to the customer relative to the amount the customer must pay if energy prices increase. The increase in energy prices would "narrow" the gap between the book value and market value of the assets, thus lowering the theoretical stranded costs that the customer should have to pay for. However, the calculation of stranded costs is a one-time event and the bonds and the interest rate on the bonds are issued based

on that one-time calculation. The customer is then stuck for the fixed fee and pays higher rates than if the fee were allowed to fluctuate. Conversely, bondholders assume the risk if energy prices fall.

IMPLICATIONS FOR STATE AND LOCAL REVENUE

Electric utilities have been major taxpayers for state and local governments. Taxes paid by electric utilities have been a significant cost of providing electric energy and have been fully recoverable under traditional cost-of-service regulation. Taxes imposed on regulated utilities become part of the rate base and are passed on to the customer. This arrangement works to the advantage of the utility and the government imposing the tax. The utility can shift the burden to other taxpayers, while the governmental authority is able to collect substantial revenue from financially stable taxpayers. In addition, utility taxes are generally hidden from the people who ultimately pay them. In a noncompetitive environment the level of taxes do not generally adversely affect economic decisions. Under competition that scenario would change. Competitive markets will pit investor owned utilities, independent power producers, power marketers, and, in some cases, municipal utilities and rural cooperatives against each other. Under competition tax policy will become critical. If competitors are taxed differently, then the competitive balance would shift to those electric suppliers, all other things being equal, who are taxed more lightly. This would violate the principal that tax policy should not adversely affect economic decisions.

Most commentators agree that the move to competition will probably cause state and local revenues to decline. State and local governments will have to address the implications of the changing tax structure. Two countervailing forces may come into play--the desire to maintain revenue neutrality versus the desire to encourage competition. Changes in tax policy will likely involve some balance between these two goals.

MONTANA AND THE FUTURE

This article has attempted to briefly summarize some of the trends and issues related to the restructuring of the electric utility industry. The Montana Legislature jumped headlong into restructuring with the enactment of Senate Bill No 390, The Montana Electric Utility Industry Restructuring and Consumer Choice Act. The bill provides that all customers will have a choice of their electric supplier by 2002. The legislation also maintains universal system benefits programs, continues the Public Service Commission's involvement in the regulation of retail transmission and distribution systems, gives rural electric cooperatives the option to enter the competitive market, and allows utilities to recover their transition (stranded) costs through the issuance of transition bonds. Significantly, the Legislature created a Transition Advisory Committee to monitor and evaluate the status of electric utility restructuring. The Revenue Oversight Committee will analyze the tax implications of restructuring and

make recommendations to the next Legislature on tax policy that may be necessary as a result of restructuring. These two Committees will provide opportunity to all interested parties to help shape the new competitive environment.



INTERIM CALENDAR

UNLESS OTHERWISE SPECIFIED,
ALL ROOM DESIGNATIONS ARE IN THE CAPITOL

JUNE

June 27, Correctional Standards and Oversight Committee, Room 104, 10 a.m.

JULY

July 4, Independence Day, legal holiday

July 17, Public Employee Retirement Systems Committee, Room 104, 8:30 a.m.

July 18 and 19, Legislative Council, Yellow Bay

July 24, Joint Commission on Postsecondary Education Policy and Budget, Room 104, 9 a.m.

July 24, Committee on Indian Affairs, Room 108, 10 a.m.

July 25, Interim Property Tax Committee, Room 104, 9 a.m.

AUGUST

August 1, Veterans' Needs Joint Interim Subcommittee, Room 104, 9 a.m.

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